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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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IN THE MATTER OF THE APPLICATION OF
RIDGELINE WATER COMPANY, LLC FOR A
CERTIFICATE OF CONVENIENCE AND
NECESSITY.

DOCKET NO. W-20589A-08-0173

STAFF'S CLOSING BRIEF

On March 25, 2008, Ridgeline Water Company, LLC ("Ridgeline") filed before the Arizona Corporation Commission ("Commission") an Application for a Certificate of Convenience and Necessity ("CC&N") to provide water service in Pima County, Arizona.

On October 2, 2008, the Commission Hearing Division conducted a hearing in the instant matter.

On October 7, 2008, the Hearing Division issued a Procedural Order in this matter directing the parties to file closing briefs addressing two issues raised in hearing:

1. Whether Staff's recommendation that Ridgeline maintain a capital structure of zero percent debt, 30 percent AIAC/CIAC, and 70 percent equity is reasonable.
2. Whether Staff's recommendation of an Order Preliminary in the instant matter is necessary and/or appropriate pursuant to A.R.S. § 40-282 and prior Commission Decisions.

Staff hereby presents its closing brief.

BACKGROUND

Ridgeline has requested a CC&N covering approximately 632 acres of land in Pima County, Arizona, southwest of Tucson known as Ridgeline Estates. The area is currently owned by Ridgeline's parent company, Pollux Properties, L.L.C. ("Pollux" or "Parent"). At full buildout, Ridgeline Estates will consist of 136 single family residential units on lots of 4 to 5 acres. Ridgeline has proposed to fund construction of the backbone infrastructure needed to serve through a

1 combination of Advances in Aid of Construction ("AIAC"), Contributions in Aid of Construction
2 ("CIAC"), and equity. At the end of its fifth year of operations, Ridgeline anticipates that its capital
3 structure will consist of 54 percent AIAC/CIAC and 46 percent equity. Staff does not believe this
4 ratio provides the utility with sufficient financial security and has instead recommended that the
5 Commission order Ridgeline to achieve a ratio of no more than 30 percent AIAC/CIAC and 70
6 equity.

7 **LAW AND ARGUMENT**

8 **I. STAFF'S RECOMMENDED CAPITAL STRUCTURE IS REASONABLE**

9 Two of the primary factors Staff considers in determining the appropriate capital structure,
10 experience of the proposed operator and financial health of the parent company, were of particular
11 importance in the instant matter. As the record shows, to date, Ridgeline has no operational history.
12 And in the absence of such history, Staff has no way to evaluate the utility's ability to serve.
13 Therefore, Staff next looks to the company's financial health.

14 For a new utility, the primary indicator of financial strength is its equity position. The greater
15 the equity, the more financially stable the utility is likely to be. In cases in which the utility is new,
16 or not yet financed, Staff next looks to the financial strength of the parent company, since the parent
17 company is the most likely entity to which a struggling utility will look. In this case, Staff looked to
18 the financial strength of Pollux. Staff's concerns were not alleviated by what it found.

19 Pollux's 2007 unaudited balance sheet and income statement reported total equity assets of
20 approximately \$3.97 million and total liabilities of approximately 3.96 million for total equity of
21 \$15,639 and net income of \$703. Staff was concerned that Ridgeline did not have adequate financial
22 capacity to provide the requested service and that in the event Ridgeline met with financial trouble, it
23 was unlikely that Pollux would be able to provide assistance.

24 For new CC&Ns with companies with little or no operating experience, Staff prefers a capital
25 structure of 100 percent equity infusion by the utility. In Staff's experience, when a company's
26 capital structure is made up solely of advances or contributions, the company's rate base will be zero,
27 and when a company has not invested any capital, there is no incentive for the company to operate
28 efficiently. With respect to AIAC, even though Commission Rule R14-2-206 states that advances will

1 be returned at a rate of 10 percent per year, oftentimes companies can only partially return the
2 advances, and the rate base on which the companies should be earning is diminished or zero. If the
3 investment in plant depreciates and it is not replaced with either more contributions or advances, the
4 system can become dilapidated and less secure for providing service. Therefore, to alleviate Staff's
5 concern, Ridgeline indicated that Pollux would either invest as equity owners of Ridgeline or assist in
6 raising \$1.8 million.

7 As Staff witness Crystal Brown testified, Staff's recommended capital structure encourages a
8 company to be more concerned about its investment. TR 186:17-19 Ms. Brown also testified that the
9 Staff recommended equity ratio helps the company in that it helps to ensure that the company will
10 have a rate base that is large enough to earn an adequate rate of return. (TR 186: 5-8) Staff
11 recommends higher equity to maintain adequate rate base. Higher rate base means that the utility is
12 earning a return on a greater investment. This is important to help avoid steep future rate increases
13 which sometimes result from a utility's inability to replace existing infrastructure out of the meager
14 returns on a miniscule rate base investment.

15 Staff, *In the matter of the application of Beaver Dam Water Company, Inc.*, recommended that
16 the utility achieve a capital structure of 70% equity, 30% AIAC/CIAC, because the utility was
17 applying for a new CC&N to provide wastewater services. The Commission, in Decision No. 70205,
18 instead ordered Beaver Dam to achieve a capital structure of 40 percent equity, 0 percent debt, and 60
19 percent advances, partially in recognition of the fact that Beaver Dam had 20 years of experience in
20 the water utility industry and hired a certified operator for its wastewater facility. Ridgeline, however,
21 has no such experience and therefore, no such deviation from standard recommendation should be
22 allowed in this matter.

23 Under these less-than-optimal financial conditions, Staff continues to support its
24 recommendation that Ridgeline reach a total capitalization consisting of no more than 30 percent
25 AIAC/CIAC and 70 percent equity by the end of its fifth year of operation. In order to ensure
26 adequate capitalization to protect the public interest, Staff's recommendation is appropriate,
27 reasonable and should be adopted.

28 ...

1 **II. AN ORDER PRELIMINARY IS APPROPRIATE AND SHOULD BE ADOPTED**

2 On September 5, 2008, Ridgeline filed a supplement to its application, the purpose of the
3 supplement was among other things, to address the Company's lack of financial capacity. In its
4 supplement, Ridgeline proposed to convert its debt, which is in the form of Deeds of Trust to equity
5 to alleviate the high level of debt in the Parent's capital structure. According to the supplement, each
6 of the investors in the Parent agreed to convert its current beneficial interest under a Deed of Trust
7 into an equity ownership in the Parent. Ridgeline also stated that the investors in the Parent were
8 prepared to either directly invest as common equity owners of Ridgeline or assist in the raising of the
9 projected \$1.8 million in common equity for the Company once it received a CC&N authorizing it to
10 provide water service to Ridgeline Estates. Based on the supplement, Staff revised its Staff report and
11 recommended that an Order Preliminary be issued to Ridgeline provided that certain conditions are
12 met.

13 ARS 40-282 (D) states:

14 "If a public service corporation desires to exercise a right or privilege under a
15 franchise or permit which it contemplates securing, but which has not yet been
16 granted to it, the corporation may apply to the commission for an order preliminary to
17 the issue of the certificate. The commission may make an order declaring that it will
18 thereafter, upon application, under rules it prescribes, issue the desired certificate,
19 upon terms and conditions it designates, after the corporation has obtained the
contemplated franchise or permit or may make an order issuing a certificate on the
condition that the contemplated franchise or permit is obtained and on other terms and
conditions it designates. If the commission makes an order preliminary to the issuance
of the certificate, upon presentation to the commission of evidence that the franchise
or permit has been secured by the corporation, the commission shall issue the
certificate."

20 As ALJ Martin noted during the hearing, "...order preliminaries are not used that frequently."
21 Staff does not dispute this. However, in the exercise of its discretion, the Commission has granted
22 Orders Preliminary where the factual circumstances have warranted it and has expanded the grant to
23 involve other than franchise or permit.

24 The Company in its initial brief has cited several Commission decisions where an Order
25 Preliminary was granted. According to Ridgeline, the common theme seems to be Order Preliminary
26 are only appropriate in 2 circumstances; where there are unique circumstances or a company has
27 requested an Order Preliminary or where there are unresolved issues that are beyond the control of
28 the applicant. Staff would strongly disagree with interpreting any Commission order as a limitation of

1 the authority of the Commission to act as it deems appropriate to protect the public interest in the
2 exercise of its statutory authority. However, there are other factual scenarios in which an Order
3 Preliminary may be appropriate.

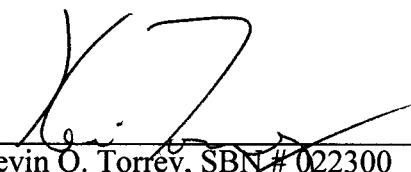
4 The Commission has issued an Order Preliminary in a circumstance where there were no
5 unique circumstances nor were there "issues" between the applicant and Staff. In Decision No.
6 69399, *In the application of Empirita Water Company, LLC*. In Empirita, there were several Staff
7 recommendations that were within control of Empirita, such as the filing of a curtailment tariff; the
8 filing of Approval to Construct, as are required by Ridgeline. Staff recommended that the
9 Commission issue an Order Preliminary to Empirita. The Commission adopted Staff's
10 recommendation.

11 Finally, it should be noted that the utilities that were the subjects of the Decisions listed by
12 Ridgeline in its initial brief (Johnson Utilities, Palo Verde Utilities, Arizona Water), all held *existing*
13 CC&Ns. Ridgeline, on the other hand, is requesting an *initial* CC&N.

14 III. CONCLUSION

15 Ridgeline has no operating experience. Not only has Ridgeline not yet established a reliable
16 financial history, in the event that financial hardship arises, it is unlikely that Ridgeline will be able to
17 look to its parent company for support. Under these circumstances, an Order Preliminary, together
18 with Staff's recommended capital structure, is entirely appropriate and should be adopted.

19 RESPECTFULLY SUBMITTED this 8th day of December, 2008.

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1 Original and thirteen (13) copies
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